RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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January 14, 1977 **LETTER 686**

Dec. 31, DJIA 1004.15; PTI 820; A-D ratio -18.74
Jan. 7, DJIA 983.13; PTI 824; A-D ratio -18.78

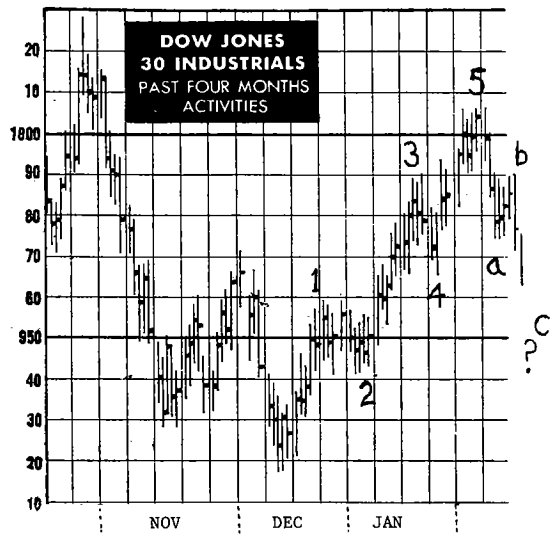
THE PICTURE: I guess it's about time to repeat my old thesis that "The market always does what it has to—to drive the greatest number of investors out of their skulls." As the year 1976 drew to a close, the consensus was that "The Dow (along with the rest of the market) would roar up to some kind of important top in early 1977" ("Dow 1100 to 1150" was the popular upside target). Skeptic that I am, I didn't go along with the consensus forecast.

The market was quite "over-bought" by year end, and there was much puffing and straining in the Dow. Moreover, I noted (see last Letter, page 6) that the Dow had rallied off its November low (see chart) in a perfect Elliott series of 5 minor waves. Following the 5th leg, I wrote, there should be an a-b-c type reaction which would serve to correct the November-December rise.

As it turned out, the 5th minor leg was completed by the time I wrote Letter 685. Consequently, the Industrials greeted the New Year with a resounding little plop (an action which could hardly have surprised any of my subscribers). The Dow dropped back to 978.06 on January 5, forming "a leg" of a potential a-b-c corrective pattern. It remains to be seen how the pattern will actually evolve. A rally to 983.13 completed the "b leg," and as this is written the Dow has dropped precipitously below leg a. Thus the "c leg" (and hopefully the wind-up) is now underway.

Let's turn a moment to the Dow Theory. Note on the page 1 chart that the Transports have steadfastly **refused to confirm any and all Dow weakness.** Important non-confirmations, non-confirmations which carry bearish implications, usually produce weakness **fairly fast.** Yet the series of unconfirmed new highs in the Transports Average (including the Jan. 3 bull market high of 237.52) have **failed to produce weakness** in the general market and have produced only token weakness in the Dow. This is a ***good sign.*** It suggests to me that when the Dow is through "messing around" with its current corrective pattern, it's going to head higher. Before 1977 is out, the Dow is going to head ***importantly higher.***

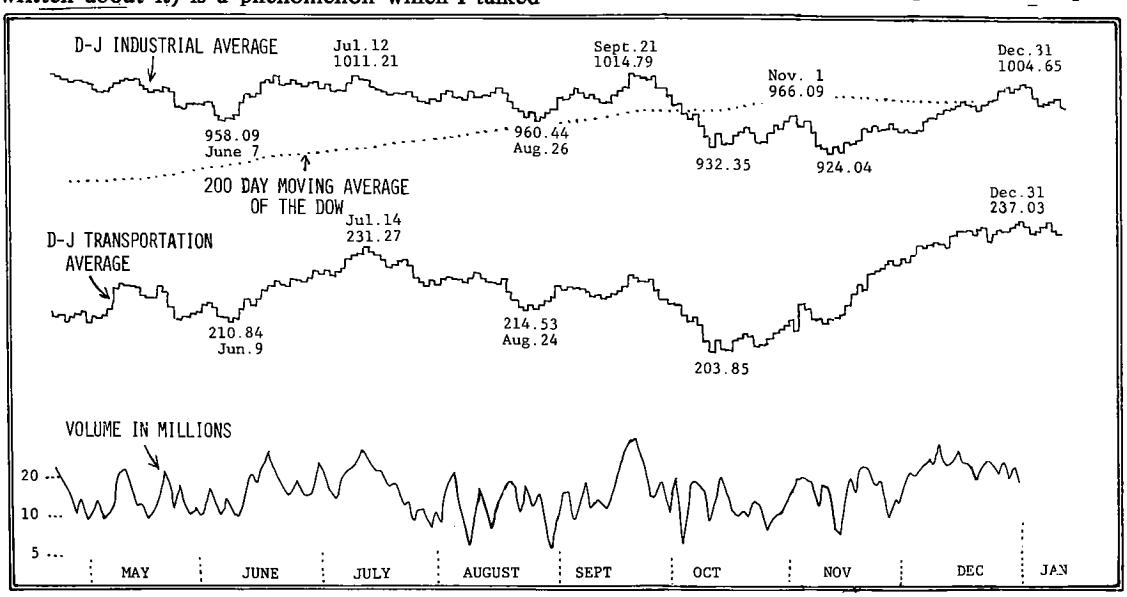
Almost unknown to the great majority of investors (I haven't seen a thing written about it) is a phenomenon which I talked

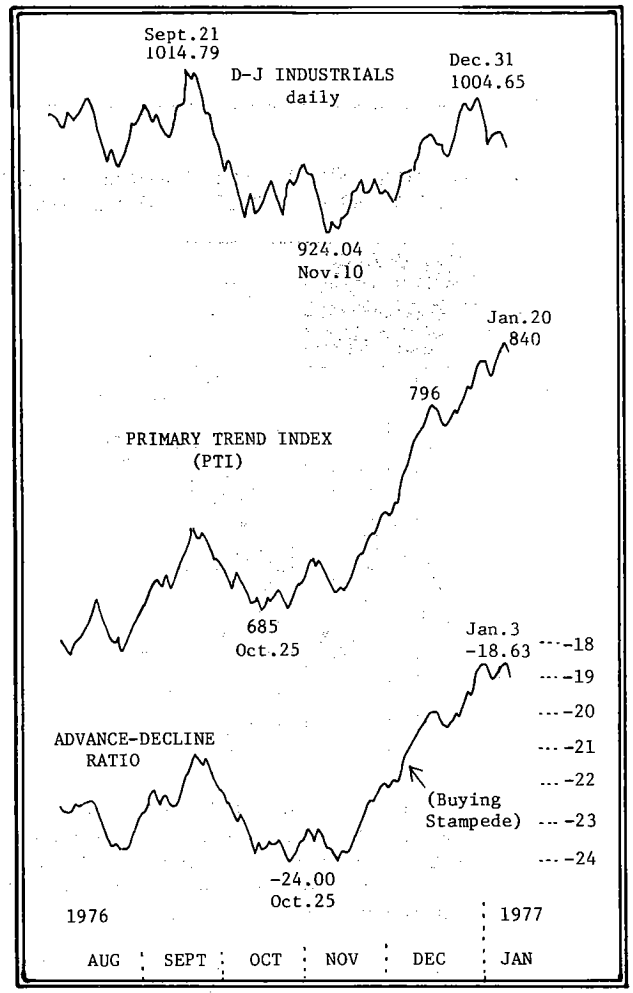


about in the last report. A *"buying stampede"* has been in progress. It started on October 25 when the A-D Ratio turned up. By December 31 the A-D had gained 5 full points (see chart) without so much as a 1 point correction. This is the formula I have always used to identify a buying or breadth stampede!

In truth, I have never seen anything quite like the current situation. Here is the *A-D Ratio* (which measures the stock action of the majority of issues) climbing steadily and persistently higher for almost 3 months. **And nobody seems to notice it!** And everyone is still nervous and on the edge of their collective seats. I have to call this action bullish. It means that stocks are going up (I should say "sneaking up") without the public and most investors understanding what is going on.

You will note also that the *Primary Trend Index* (PTI), which is my own composite made up of 8 critical averages and technical measurements, continues to register new bull market highs. This is telling me that the basic power of the primary bull trend





continues very much in force. And all this without the Dow really participating. It's truly extraordinary.

What will the resolution be? How will it ultimately work out? The reluctant Dow can bring down the market in a corrective phase. Or the market can continue strong, waiting patiently for the Dow to correct itself—and then, when the Dow gets in gear on the upside and finally climbs firmly ***above 1000*** the whole picture can emerge with tremendous, ***obvious*** and ***visible*** bullish force.

My own feeling, this being a bull market, is that the bullish resolution is the one that is going to occur. I don't give a damn whether it happens this month or in June, I don't care whether there is another week or another three months of backing and filling, I think the bull is going to end up charging ahead with his full power. Remember, the longer the primary bull trend is held back (and it's been almost a year now!) the bigger the ultimate upside movement.

To operate at all in the stock market (while retaining your sanity and your solvency) you have to have **principles.** The guiding principle which we have adhered to in this bull market is to buy *values* and to *sit out* the squalls and the black clouds. Before this bull market has breathed its last, I expect the sun to come out in full, and I expect the public to be out there with their swim suits, their picnic baskets and their new cars. Remember, just as men find release in tears and grief, they also find release in wild celebrations and all-night parties. By the same token, bear markets take stocks down, way down. But bull markets (and we are in one now) don't simply take stocks back to reasonable values, they take them **above and beyond reasonable values.**

We are still in the deceptive second psychological phase of this bull market. Historically, the second phase of a bull market has always been a devil to get through. The second phase is characterized by large interests accumulating, by a fickle public which nibbles and runs, by erratic news, by market reactions, by deceptive and erratic market movements, and by general confusion on the part of the public and most of the professionals.

Somewhere ahead things are going to look a good deal better, and this second phase is going to come to its conclusion. That conclusion will probably be marked by a vicious correction. Then the market will prepare for the third speculative phase. But let's worry about all that when we get closer. For the time being, we'll hang on and watch the Dow. Once that Industrial Average gets above 1000 and holds there, I think we're going to see some upside surprises. In the meantime, my 13-week momentum line of the Dow is pushing closer and closer to a ***major*** upside reversal. I'll try to cover this development in the next report.

ADVANCE-DECLINE RATIO: I have been studying and writing about the Advance-Decline Ratio ever since the early 1960's. In the mid-1960's I published (together with Dan Merkle of St. Louis) the first chart book of the A-D ratio, this in an attempt to provide market students with an overall view and feel for this valuable indicator. A few years ago I published a new and larger edition of the A-D Ratio Chartbook, taking the daily A-D line (with the Dow) back to 1930). Copies of this loose-leaf volume are still offered here, $35 per album ($37.10 to Californians).

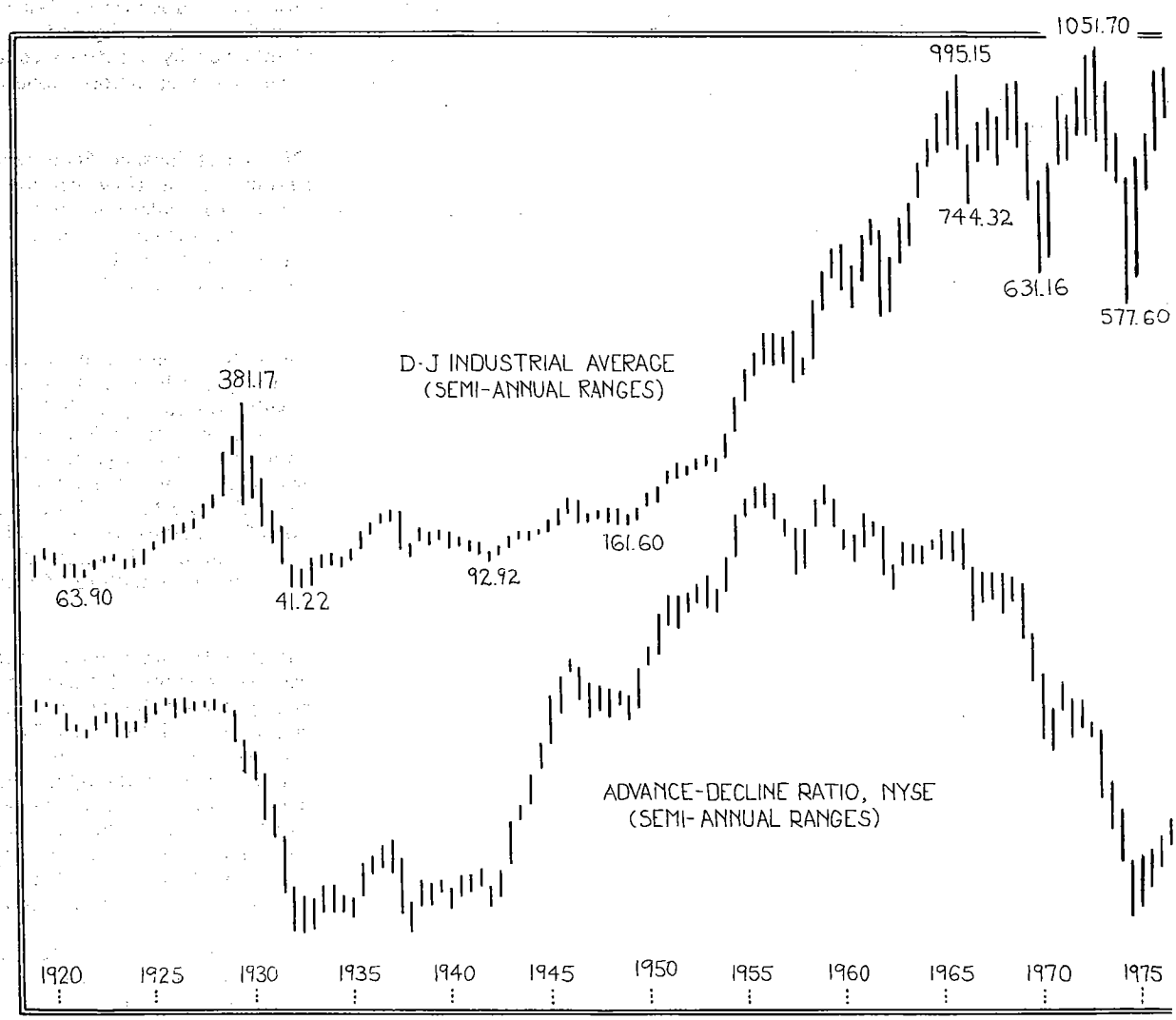
The Advance-Decline Ratio was conceived by James Hughes of NYC working jointly with Colonel Leonard Ayres of the Cleveland Trust Co. They did much of their original work back in the 1920's and before. During the 1950's and '60's Hughes wrote a market letter (based on A-D Ratio action) at Auchincloss, Parker, Redpath. I used to read this report religiously, and on occasion I would talk to Hughes about some point or other that I did not understand. As I got to know more about the A-D Ratio (with Hughes' help), I introduced it in Dow Theory Letters.

It seems hard to believe now, but in the early 1960's the A-D Ratio was relatively unknown on Wall Street. In the introduction to the chart books, I termed the A-D Ratio "the single most valuable aid to technical analysis," after (of course) the Averages themselves. I still hold to that opinion.

As the A-D Ratio became more familiar to Wall Streeters, variations and sundry sophisticated formulas were introduced. Some of these were excellent, most were not. Hughes himself insisted that only the *daily* A-D line was significant, and he had little use for the combined weekly and even monthly A-D Ratio computations. I tend to agree with him, and I only use weekly or monthly charts when they are composed of the *daily* high and low for each period.

Hughes always used the A-D Ratio in conjunction with the Dow Industrial Average, observing whether the movements of the two were progressing in **harmony** or whether **divergences** were occurring. History demonstrates that the Dow and the A-D tend to move in harmony, and where divergences (dis-harmony occurs), the market will usually erase the entire movement which caused the dis-harmony.

Hughes was also well aware of the power of money and bank credit. The figures Hughes used when attempting to identify a market top were the commercial banks' holdings of US Treasury obligations. As long as the banks' Treasury holdings were building up (i.e., rising liquidity), Hughes believed that the situation was healthy on the long–term basis. In fact, he noted that all major market tops were accompanied by (1) a divergent series of movements in the Dow and the A-D Ratio, and (2) a declining trend in the banks' holdings of Treasury obligations.



Alright, let's apply this criteria to the present situation. Currently we have a breadth-price structure wherein the Dow recorded its high on September 21, 1976 at 1014.79. The A-D Ratio recorded an unconfirmed high more than three months later on January 3, 1977. Thus we have a very definite non-confirmation, one that will certainly allow for a correction. At the same time, the commercial banks' holding of US Treasury obligations (my latest figure is December 15) hit a **new bull market high** of $100.5 billion, almost $9 billion above the September total. Thus, bank liquidity continues to *improve*, a situation which allows for a market correction but not a major bull market top.

Many market students entertain the idea that a strong A-D in the face of a laggard (non-confirming Dow) is a strong situation, but a strong Dow with a non-confirming A-D is a weak situation. Not so, both situations represent a picture of technical dis-harmony and the first can as easily produce a reaction as the second.

Owners of the A-D Ratio chart books need only turn to the year 1934 to satisfy themselves regarding the correctness of the above statement. At that time (1934), the Dow hit a peak in early-February, simultaneously with the A-D Ratio. This set off a decline which carried into late-March, whereupon a new rally began. By early-April the A-D Ratio had surged to a new high, but the Dow failed to confirm. This seemingly "healthy non-confirmation" on the part of the Dow was followed by a nasty decline which carried into July. The decline resulted in a loss of over 20% of the Dow's value, although it by no means ended the bull market of 1932-37.

Variations on this same theme of highs in the A-D unconfirmed by the Dow (followed by corrections) occurred in early 1940 and mid-1941.

All of which brings up the question, "Could we be on the edge of a full-fledged correction at this time, one perhaps as great as the 20% correction of 1934?" My answer is that anything is possible on Wall Street, but I personally doubt that we're going to see a major secondary "wash-out" at this time. But that's another story covered in another part of this report. Right now, I want to go into the very long-term picture, as illustrated on the accompanying chart.

I have drawn the *semi-annual* high low ranges (two bars per year) covering the years from 1919 to the present. In other words, each vertical bar on the A-D Ratio represents the daily high and the daily low for a six month period, with two bars making up each year. The Dow Industrial Average is shown in the same way.

It's fascinating to study the price-breadth history as shown on this chart. Note that after the 1929-32 collapse, both price and

the A-D formed a long base-like structure, lasting from 1932 to 1942 (even the 1932-37 bull market appears as part of this massive base). In 1942 the general market and the Dow was selling at some of the lowest valuations ever seen. From the 1942 lows, the A-D Ratio mounted the most massive and persistent advance in stock market history. For four years everything on the Board simply headed up. By 1946 the A-D had pushed back to the vicinity of the 1929 highs.

The 1942-46 bull market ended in May 1946, followed by an August crash. During the next three years (until June, 1949) the A-D and the Dow moved sideways as another major base was formed. This was followed by a second explosion in both the A-D and the Dow. By 1956 the A-D had progressed almost as far as it had during 1942-46.

In 1956 a strange phenomenon occurred. The majority of stocks, as measured by the A-D Ratio, stopped advancing. From this point on, the market became more selective, the Dow pushed higher, glamor and growth stocks (the new darlings) roared into space. But the inroads of inflation and higher interest rates (among other things) were taking their toll of smaller businesses. Reflecting this "majority disease," the A-D Ratio started down.

In 1966 the great 1949-66 bull market topped out. While the mass of stocks continued to slide lower, the Dow (fed by massive Government infusions of money) ran up and down as if possessed. By 1973, with the A-D Ratio deepening its slide, the Dow was exhausted, and the time of reckoning had come. The A-D Ratio plunged during 1973-74 to levels not seen since the 1930's. This time the Dow joined the carnage. The unweighted Averages (indicative of the average stock's value) plunged to unbelievable lows, many losing 80% to almost 90% of their values. The crash could only be likened to that of 1929-32.

From its low on October 23, 1974 (minus 36.52 on my A-D chart), the A-D and the Dow started up. Having called December, 1974, the absolute bear market bottom, I wrote (as early as January 15, 1975, Letter 619), "I feel that it is a real possibility that we will never again in our lifetime see the A-D Ratio at the depressed levels of December, 1974. Those **same levels** measured the worst of the Great Depression in 1932, those levels in 1938 measured the coming horrors of Hitler, World War II, and a civilization that very nearly went under. Perhaps at the December 1974 level, the A-D Ratio was discounting the worst of a world beset by illiquidity, inflation, unemployment, fiat money and political incompetence. Remember, once you discount the bottom, there is nothing left to do but start discounting the next top."

I will still stand by that statement, made a month after the Dow bottom in early 1975. I believe the 1974 bottom represented an historic A-D low point. From the 1974 low, the A-D rise has proved spectacular. As you can see on the chart, the A-D has risen for four six-month periods in a row, something it has not been able to do since 1956. During the same period the Dow has virtually doubled in price. But one thing is clear on this chart, and that is that the recovery in the average NYSE stocks has been far less than the recovery in the Dow.

This raises the question of "What happens from here?" My guess is that the A-D ratio has a considerable distance to go on the upside before the bull breathes its last. But get this firmly fixed in mind. Only **once since 1919** has the A-D been able to make substantial upside progress for five semi-annual periods in succession. That "once" was during the 1942-46 bull market when there were eight successive semi-annual periods of substantially higher peaks in the A-D. If the A-D can push substantially higher during the first half of 1977, it will be doing something that it has only done once before since 1919. That could happen, but it is asking a lot.

All of which has to do with my statements in the last two reports to the effect that the market might not oblige the current consensus which is looking to a good move to new highs during the first half of 1977. My own guess was and still is (see the last page of Letters 684 and 685) that we will see irregularity and correction during the first half of 1977 followed by a **better second half.** In this thinking, I believe I am standing almost alone among Wall Street market students.

THE NEW KING PENSION: I just finished Peter Drucker's new book, "The Unseen Revolution, or How Pension Fund Socialism Came to America." I was particularly interested in this book, because Drucker is one of the few really brilliant "futurists," and because I have had the opportunity to observe what is happening in the pension area myself. To put it very mildly, pension money is taking over.

I want to put down in very concise form some of the points made in Drucker's book, and I am doing this because I think it will have increasing effect and meaning (as time goes by) in all our lives. (1) The pension funds now own about 25% of the equity of American business. About the only major segments of American business that the pensions do not control is farming, small business, mutual insurance companies and the bankrupt railroad. (2) Funds now collect 35% of all dividends, the tax collectors take in another 35%, and investors absorb the remainder. Thus the traditional investors now absorb only one-third of corporate profits.

(3) The pension fund owners (the US workers) are absentee voters. They normally entrust management of their stocks to banks or institutions. The latter generally stay out of corporate affairs; if they don't like the action they sell the stock. This tends to produce self-perpetuating managements, responsible only to themselves. (Example—and this is my own thought, what the devil happened to the incompetents at the big banks who authorized billions of dollars worth of lousy loans? Where are all those idiots, and why don't we hear about them. If I ran my business that way, I'd be broke. What's the story on the bank loans? Where are the investigations, the falling heads? Anyone know?)

(4) The average age of the US population is shifting to the older end, the center of political gravity has already switched to the elderly! Thus, the economic burden is growing. Three workers now support each retiree. Within 10 years two-and-one-half workers will support each retiree.

Now here is the meat of the whole thing. (5) Drucker foresees **painful cutbacks** coming in almost every segment of the US except pension costs. The various "establishments," military, educational, disadvantaged, blacks, housing, hospitals, etc., ALL this will have to *contract* because capital will become increasingly scarce. And MOST IMPORTANT, the politicians will be giving more and more priority to **what the elderly want**, and they want **less inflation** (since they see inflation as their worst enemy). All this will bring *new stresses*, the aged against the unemployed, young against old, vested interests against the new orders, etc.

And here are my own comments. There is no question in my mind but that the US pie is going to shrink. This is going to put increased investor emphasis on yields, income, stability. This is one reason why bonds are now coming into their own. The day of the "growth stock" with a ½% yield is waning, and the day of the income producing bond-portfolio has arrived. There will be increased interest on the company with a fine dividend record, the company that can produce a profit and translate that profit into dividends. There will be increased emphasis on the conservative money manager, the man who can handle the money and produce *income*.

Conclusion: Expectations in all segments of the nation and its economy are going to be reduced. The "growth at any cost" concept is going the way of the dinosaur. Increased emphasis will be placed on expert, intelligent money management. Yield

and income are going to come back into their own. All this fits in my repeated emphasis this year and last on bonds, bonds, and more bonds.

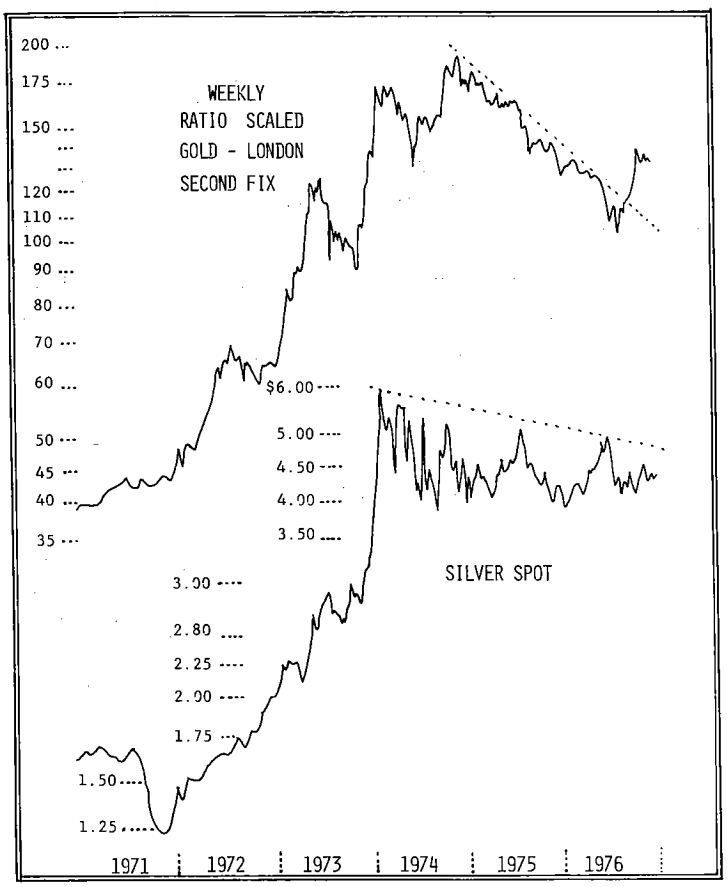
QUESTION: How do "Lower expectations" fit in with your thesis that we are in a primary bull market? I don't see the logic in this.

ANSWER: I believe that lowered expectations will ultimately be seen as sane, practical and jibing with reality. There's nothing bearish about a nation that's been living in a perpetual binge and finally *coming back to reality*. The fact is that the greatest part of any market movement (bull or bear) is produced by major *swings in price-earnings ratio.* At the 1974 lows, the P/E for the Dow hit 5.8, lowest level in modern history. That reflected the lowest level of confidence in the future of the corporation, corporate profits and the nation that any of us have ever seen.

The P/E on the Dow is probably around 10 now (less if you take into consideration the new replacement accounting). Yet at the peak of confidence (during the last bull market) in 1961, the Dow P/E got as high as 24.2. This should tell us the story. Suppose, for the sake of argument, earnings on the Dow increase moderately during the next few years BUT the P/E on the Dow rises just halfway back to the 1961 high (in other words, back to 15). I'd say that the kind of confidence that could produce a 15 P/E could also bring on one hell of a bull market.

Now one absolute necessity, if confidence is to increase, is lowered inflationary expectations. Nothing discourages Wall Street and Main Street more than inflation. And lowered general expectations will tend to produce a decreased rate of inflation. That's why I say that a bull market can indeed be mounted on lowered expectations. And I think that's what is going to happen.

GOLD: Question: "Russell, you've stated in recent Letters that the August low of 103.50 was THE LOW for gold bullion, and you also said that a new bull market in gold has started. Then, in the last report, you warned that gold may not be in a bull market,



and you suggested selling gold (in the 135-138 area) and buying it back IF it hit 140. What's happening, how can you reverse yourself?"

Answer: I put out a report every 10 days because the market changes, and what I see changes, and I sometimes change what I think. If the market was static, I could put out one Letter a year and spend the rest of the time sunning myself on the La Jolla beaches. That hasn't happened yet.

In the last Letter I pointed to a possible new development in gold, the inability of bullion to mount a new advance above the Nov. 15 peak of 138.85. Failing to better 138.85, I stated, would imply that gold was probably completing a classic 1-2-3 bear market rally (rather than starting a new bull market). For that reason I advocated selling gold at around 135 (the price at that time) and buying back IF gold hit 140.

Unfortunately, my misgivings about gold could now be materializing. Gold has backed off rapidly, breaking below its 34-day moving average (which is currently 133) and heading for its recent important low of 128.65 (recorded on Nov. 18). It's not good action.

The whole primary bear market in gold took the metal from its 1974 high of 195 to its 1976 low of 103. A move halfway back would have taken gold to 149. It failed by 10 points to return to 149. This had negative implications. The next important level is the halfway level of the rise from the 1976 low to the November 1976 high of 138.85. That halfway mark is 121. The level of 121 now looms as most important for gold.

So far, gold (in failing to better 149) has shown its inability to regain even half of its 1974-76 bear market losses. The second test is near. If gold breaks below 121, it will have failed to hold even half of its gains since the 1976 low. To put it bluntly, gold had better hold above the 121 level. If it cannot, I would say that gold is almost surely still in a primary bear market. And in time it will break to new lows, below the 1976 low of 103.50 and below the 100 level.

Silver, ah silver, the experts have been saying that silver ("the poor man's gold") is an even better inflation hedge than gold. And it may well be, but according to my weekly chart, nobody's been hedging in earnest yet. Silver is still in a downtrend, and it would require about $5-an-ounce silver to turn the chart bullish. I'm not telling you to turn in your wedding silverware, but neither would I be hoarding silver bars—not yet, at any rate.

LATE NOTES: The market always looks lousy when it's going down. It always looks great when it's going up. The Dow is correcting as I write this, and to add insult to injury, the bond market (after its sensational run-up) is correcting too. The big honchos were obviously speculating in long-end Governments, buying them on 10% margin and socking away up to six points within a one month period. Suddenly, everyone wants their profits and Governments have fallen with a thud. It happens that way.

But it's not the end of the world, nor is it the end of the bull market in bonds and stocks. What I am watching now is the action in the **Transports**. I'm interested to see whether Transports match Industrials in willingness to decline. Since the page 1 chart is drawn to ratio scale, this is an easy place to gauge the rate of movement in the Averages. So far, Transports continue to outperform Industrials.

Having watched Wall Street for a long, long time, and not being a wise-guy, I have learned always to pick the potential danger signals well ahead of the event. So the question might be (should be) asked, "At what point do you take the money and run?" The October-November lows are the critical points for this market, Industrials at 924.04 and Transports (far down the line) at 203.85. If those two points were to be jointly broken (and I sincerely doubt they will be), I would say that the second phase

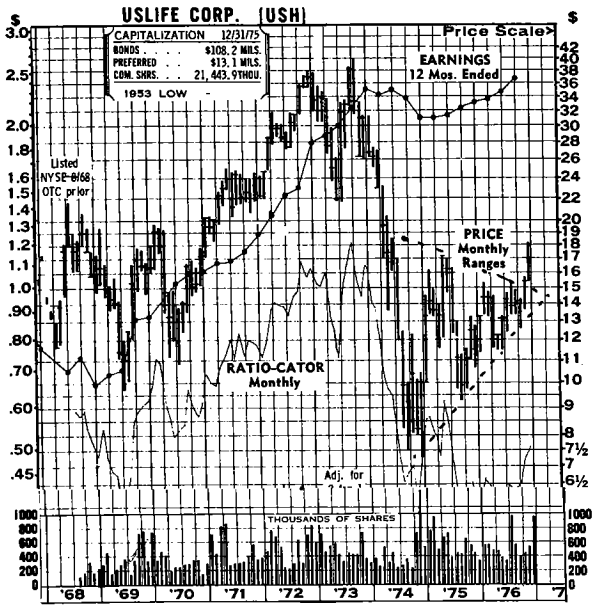
had ended and a severe reaction was underway. It could happen, anything can happen on Wall Street, but I just don't think it will.

I am also watching the A-D Ratio, and I am most interested to see whether the A-D Ratio can (in the face of this corrective action) possibly hold its losses to under 1 point. If it can do that, it will (1) be showing remarkable strength, and (2)signal that the buying (breadth) stampede is still intact. I must admit that I don't think I have ever seen a buying stampede hold together while the Dow was correcting, and I don't know if it can happen. But if the A-D Ratio does hold (by some miracle) its losses from its January 3 peak to less than 1 point during this correction, we will have an amazingly strong breadth picture. These little items, by the way, are the kinds of things that make the market such an exciting study as far as I am concerned.

STOCKS: I spent most of last night going through Security Research's long-term (monthly) chart books of 1100 important stocks (Sec. Res., 208 Newbury St., Boston, MA 02116). What I see there is a great many stocks still in major bases, a good many stocks well out of their long-term bases, and very few stocks looking as if they're topping out for the duration. I would think that any broad market weakness here would just push most equities back into or towards their bases, but the signs of big distribution are not there (or at least I don't see them).

There are a lot of patterns showing what are characteristic of the early and even the second phase of a bull market, but you don't see this kind of action at or near the end. To illustrate, I have included a number of typical charts on page 6. The pretty accumulation patterns are all there. There are the symmetrical triangles and breakouts in *GATX* and *US Life*, the ascending triangle and breakout in *Amer. Brands*, the head-and-shoulders bottoms in *Rockwell* and *Chemical of NY*. They all look good, they all appear to be under accumulation, they're typical of dozens and dozens of NYSE charts.

NEW PAGES: For all those who purchased chart albums of either the A-D Ratio or the D-J Averages, the 1976 pages are now in process. These pages covering the daily action will also include key political and social events of the year. I MUST KNOW roughly how many pages to print, and I therefore request all those who wish to update their albums to please send in your order now. Price is $2 per page, or $4 for the new A-D page and the new D-J page. **PLEASE**, do not hold off, I need to know now.



NEXT MAILING: January 26th